Aurora
ENERGY LIMITED

Cross-submission

GPB DPP – Policy settings for the 2017 reset

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DELTA
THINK.INFRASTRUCTURE

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Table of Contents

1 Introduction

Aurora welcomes the opportunity to provide this cross-submission in relation to the Commerce Commission's *Default price-quality paths for gas pipeline services from 1 October 2017: Policy for setting price paths and quality standards, 30 August 2016*.

No part of our cross-submission is confidential and we are happy for it to be publicly released.

If the Commission has any queries regarding this cross-submission, please do not hesitate to contact Alec Findlater:

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2 Potential precedent for 2020

Aurora recognises that the Commission's decisions on gas pipeline DPP price resets have the potential to establish precedent for the next electricity distribution DPP price reset.

There is a clear progression from the 2015 EDB DPP price reset feeding into the 2017 GPB DPP reset, which we consider would be likely to continue on into the 2020 EDB DPP price reset.

By way of example, we note that the Commission grappled with the issue of how to set capex and opex growth projections in the 2015 EDB DPP reset, including the aborted proposal to penalise some EDBs with a 10% capex growth cap, and is facing a continuation of these challenges for the GPB DPP reset.

3 Role of AMPs

Aurora supports the view that the Commission should "*use suppliers' own expenditure forecasts when setting DPP capex and opex allowances*" including "*more use of AMP forecasts when developing regulatory price paths*"[1].

Aurora previously agreed with the Commission, in the EDB DPP 2015 reset consultation, that "*Within certain limits*" it should rely on "*each distributor's forecast to model their capital expenditure*"[2], but that "*the Commission needs to ensure that it has a reasonable evidential basis for forming the view that an EDB has systematically biased their forecast before imposing a penalty, and that it does not curtail efficient, and reasonably forecast, capex*"[3].

It does not appear contentious that AMPs should be used, as an input, for forecasting expenditure.

[1] ENA, Default price-quality paths for gas pipeline services from 1 October 2017, 28 September 2016, paragraph 11.

[2] Commerce Commission, Low Cost Forecasting Approaches For Default Price-Quality Paths, 4 July 2014, paragraph 4.2.

[3] Aurora Energy, Submission Proposed Default Price-Quality Paths for Electricity Distributors from 1 April 2015 and Low Cost Forecasting Approaches for Default Price-Quality Paths, 15 August 2014, page 20.

Powerco has noted that "*There is common ground that the Asset Management Plans (AMPs) … are an appropriate starting point*"[4].

We recognise, as Orion points out, that "*use of supplier forecasts to inform expenditure allowance decisions at price resets … will require some assurance that the forecasts are reliable*"[5].

However, we share concerns about the nature of the scrutiny the Commission is considering.

A common theme amongst regulated suppliers, as expressed by Orion, is that "*the proposals in the Policy Paper appear inconsistent with the intent of having a relatively low-cost DPP*"[6]. The ENA points out that there is a risk that the level of scrutiny may end up being more appropriate for CPPs rather than DPPs.

Both Orion and the ENA comment that the process is too subjective and "*gives the Commission wide discretion to determine what expenditure is and is not well enough justified to be included in DPP allowances*" and that "*this subjectivity will itself create costs and is inconsistent with the intent of DPPs*"[7]. Powerco has described the proposal as "*a complicated framework of bespoke proxy "metrics" and layers of increasing scrutiny*" with an emphasis on "*tailoring*" that "*is highly discretionary for the Commission and its consultants*"[8].

We support Orion[9] and the ENA's other proposals for ensuring "*Opportunities for judgement are minimised*" and "*Transparent and unbiased criteria are developed*"[10].

It would appear that further work is needed to ensure that AMPs provide a reasonable level of surety to the Commission, for price setting purposes, while ensuring that the requirements are not excessively onerous or inconsistent with the low-cost DPP regime.

If this cannot be resolved before the gas DPP reset, an interim solution may be required, such as reverting to the 20% cap applied in the previous gas and electricity DPP resets, or consideration of Powerco's three tier variant (applying a threshold below which supplier forecasts are adopted without further scrutiny, permitting reliance on supplier forecasts up to a higher threshold where the Commission is satisfied the AMP provides sufficient explanation , and if the Commission is not satisfied with the AMP, allow suppliers the option of providing additional supporting information, but otherwise default to the lower percentage threshold)[11].

At the very least, we believe that the Commission should provide regulated suppliers the surety of a 'safe-harbour' under which "*Expenditure that is within the BAU boundaries should be accepted, without further scrutiny, and that this assessment is undertaken at the total opex and total capex level*"[12].

[4] Powerco, Submission on Policy for setting price paths and quality standards: Default price-quality paths for gas pipeline services from 1 October 2017, 28 September 2016, paragraph 4.

[5] Orion, Submission on Gas DPP reset 2017 Policy paper, 28 September 2016, paragraph 6.

[6] Orion, Submission on Gas DPP reset 2017 Policy paper, 28 September 2016, paragraph 7.

[7] Orion, Submission on Gas DPP reset 2017 Policy paper, 28 September 2016, paragraph 18.

[8] Powerco, Submission on Policy for setting price paths and quality standards: Default price-quality paths for gas pipeline services from 1 October 2017, 28 September 2016, paragraph 5.

[9] Orion, Submission on Gas DPP reset 2017 Policy paper, 28 September 2016, paragraph 10.

[10] ENA, Default price-quality paths for gas pipeline services from 1 October 2017, 28 September 2016, paragraph 24.

[11] Powerco, Submission on Policy for setting price paths and quality standards: Default price-quality paths for gas pipeline services from 1 October 2017, 28 September 2016, paragraph 103.

[12] ENA, Default price-quality paths for gas pipeline services from 1 October 2017, 28 September 2016, paragraph 24.

4 Carrot versus stick: efficiency incentives

In Aurora's view, the Part 4 objective is based around using above normal profits ("limiting excessive profits" rather than precluding above normal profits) as a 'carrot' to provide regulated suppliers with incentives to invest, innovate and improve efficiency, with these efficiency gains then being available to 'share' with consumers.

Aurora shares the ENA's concern that "*expenditure allowances may in fact be set as 'stretch targets' in order to drive efficiencies into DPP price paths*" and that this may not be "*consistent with the Part 4 purpose statement, or the expenditure objective which has been proposed*"[13].

As GasNet has noted, this is "*inconsistent with the intent of incentive-based regulation. Incentive-based regulation partly decouples costs and revenues such that the regulated firms can retain the benefits of efficiency savings (or the costs of inefficiencies) for a time before sharing those efficiencies with consumers*" and "*If GasNet was to include efficiency gains in its forecasts and the Commission was to use those forecasts to set prices, GasNet would not receive any benefits from their efficiencies and thus would have no incentive to make them. Over time this would lead to higher prices and thus not promote the long-term benefit of consumers*"[14].

If the Commission uses a 'stick', with expenditure allowances reflected as 'stretch targets' or forecasts of future efficiency gains, then regulated suppliers would need to improve efficiency just to break-even, and, rather than sharing efficiency gains with consumers, consumers would receive 100% of the benefits of the efficiency gains.

Aurora considers that a 'stretch target' approach would only be likely to be desirable, if at all, if consumers were being disadvantaged (incurring higher charges than they should) because a particular regulated supplier had demonstrably excessive costs relative to other regulated suppliers. We would see this as very much the exception.

5 Reasonable investment expectations

Such an approach would also risk breaching 'reasonable investor expectations', as it is likely to heighten the risk, through the probability of forecasting error in the estimation of potential efficiency gains, that regulated suppliers would be unable to recover the cost of their prudent and efficient investment.

The ENA also expressed concern about Strata's suggestion that the Commission "*consider the lowest historical actual year to represent efficient costs and use this value for future years*)"[15]. The Commission has similarly suggested "*fall-back options*" which "*should be potentially at the lower range of possible outcomes …*")[16].

We agree with the ENA that "*Using the lowest actual year to represent efficient costs is likely to under represent expenditure requirements – there will always be years of unusually high or low expenditure requirements and these extremes are generally not good guides to a reasonable level of expenditure*"[17].

[13] ENA, Default price-quality paths for gas pipeline services from 1 October 2017, 28 September 2016, paragraph 17.

[14] GasNet, Submission on Gas Pipeline Services 2017 DPP policy paper, 28 September 2016, paragraphs 25 and 26.

[15] Strata Energy Consulting, Low cost review framework for gas pipeline expenditure – Proposed Framework and Methodology, 29 August 2016, paragraph 30.

[16] Commerce Commission, Default price-quality paths for gas pipeline services from 1 October 2017, Policy for setting price paths and quality standards, 30 August 2016, paragraphs 3.117-3.119.

[17] ENA, Default price-quality paths for gas pipeline services from 1 October 2017, 28 September 2016, paragraph 18.

We remind the Commission that submissions on the 2015 EDB DPP reset advised against the draft decision to use Year 3 as the "base year", given that expenditure was lower than normal in that year due to benign weather etc.

Just as selecting the year in which expenditure was highest would systematically bias the estimation of current and projected expenditure upward, selecting the lowest year would systematically bias the estimate downward. We do not consider that this would provide a reasonable estimate of current and projected expenditure, nor would it accord with 'reasonable investor expectations'.

6 Concluding remarks

We appreciate that the Gas DPP Policy Settings consultation paper simply reflects 'emerging views'. Our experience with other policy development processes and decisions is that the Commission is open to making substantive changes to its position. The Commission, for example, addressed many of the concerns we raised when it made its final decision on the 2015 electricity DPP reset.

Some of the proposals in the Gas DPP Policy Settings consultation paper have the potential to set undesirable precedents for both the gas and electricity sectors. This is reflected by submissions, not only from Powerco and Vector (who have both gas and electricity interests), but also Orion, ENA and, now, ourselves.

Our concerns are summarised as follows:

• Forecasting expenditure	We are concerned that the proposals for forecasting future costs that: • adopt a subjective, and loosely defined, approach to reviewing AMP forecasts; • set 'stretch targets' which factor in assumed future efficiency gains; and • err on the low-side of forecasts, (including use of the lowest-cost year as the base year); could be inconsistent with 'reasonable investor expectations' and incentives to invest; Aurora is disappointed that the Commission, and its expert consultant, Strata, has even countenanced options for forecasting expenditure, such as selecting the lowest cost year as the base year or options which are "*potentially at the lower range of possible outcomes* ...")[18]. ThIs directly parallel the concerns we, and others, had with the Commission's draft 2015 EDB DPP reset proposals to use year 3 as the base year (an abnormally low cost year), and to penalise some EDBs with a 10% capex growth limit.
• Use of AMPs	We are concerned that the way the Commission proposes to use AMPs, and the associated expectations about the information regulated suppliers would or should be able to provide, may not accord with a low-cost DPP regime. We agree with Powerco that "*The proposal sets unrealistic expectations for the available information in the AMP and from the … businesses, and will be costly and time consuming to implement*"[19].

[18] Commerce Commission, Default price-quality paths for gas pipeline services from 1 October 2017, Policy for setting price paths and quality standards, 30 August 2016, paragraph 3.119.

[19] Powerco, Submission on Policy for setting price paths and quality standards: Default price-quality paths for gas pipeline services from 1 October 2017, 28 September 2016, paragraph 5.

• Efficiency incentives	We do not consider adopting a 'stick' (through 'stretch targets'), rather than relying on 'carrots', is a suitable way to promote incentives to improve efficiency.